PENDING PROBLEMS IN PUBLIC FINANCE

BY EDWIN R. A. SELIGMAN

[*Reprinted from "Congress of Arts and Science, Universal Exposition, St. Louis 1904," Vol. VII.*]

PENDING PROBLEMS IN PUBLIC FINANCE

BY EDWIN ROBERT ANDERSON SELIGMAN

[**Edwin Robert Anderson Seligman,** McVickar Professor of Political Economy, Columbia University. **b.** New York City, April 25, 1861. B.A. Columbia, 1879; Ph.D. *ibid.* 1884; LL.B. *ibid.* 1884; LL.D. *ibid.* 1904; Post-Graduate, Universities of Berlin, Heidelberg, Geneva, Paris, 1879–82. Lecturer in Political Economy, Columbia University, 1885–88; Professor of Political Economy and Finance, *ibid.* 1891–1904. Former President of the American Economic Association; American correspondent of British Royal Economic Society; corresponding member of the Paris Société d'Economie Politique, and of the Russian Imperial Academy of Science; President of Society for Ethical Culture. **Author** of many books and articles on railway, tariff, taxation, economics, and public law.]

In addressing myself to the task of presenting a survey of the practical problems of public finance I am naturally confronted by the difficulty that the actual problems assume a different aspect in various countries, an aspect largely colored by fluctuating political, economic, and social conditions. Notwithstanding this diversity, however, there can be discerned an underlying uniformity in the modern fiscal development of civilized nations, and it will be my endeavor to point out some of the different phases of this development.

To discuss all the modern problems of finance would be impossible within the limits of a single paper. Whole groups of subjects manifestly must be omitted. The topic of expenditure, for instance, may be passed over entirely, for the reason that expenditure is chiefly statesmanship; the fiscal principles here are principles of interpretation rather than of construction. Again, the subject of public credit has been so thoroughly elaborated that the scientific problems which await elucidation are comparatively few and unimportant. The budget, also, while susceptible of undoubted improvement, especially in the theory of municipal accounting, is so closely intertwined with administration that it would be hopeless to attempt in this place to disentangle it. Finally, in the great domain of public revenue, the subject of income from government industry is of predominant economic, rather than fiscal, importance, and may thus fitly be excluded from our short survey. There thus remains only the field of taxation, a field broad enough and sufficiently hedged about by difficulties to warrant a closer examination.

There are three considerations which distinguish the modern science of finance in the study of tax problems. These are, in order, the pursuit of justice, the emphasis put upon the modern economic phenomena, and the insistence upon the conformity with economic principle. Let us consider each of these in turn.

I

The first point is well summed up in the alleged conflict between the fiscal and the social principles of finance. I say alleged conflict, because in reality there is, from a deeper point of view, no such conflict at all. It is sometimes asserted that the fiscal object of taxation is simply to secure revenue, while the social object is to effect some desirable change in social relations. This antithesis rests upon a failure to observe that finance, like economics, is a social science, and that even from the narrow political point of view of the relation between the government and the citizen, the government cannot derive any revenue — that is, cannot take any part of the social income — without inevitably affecting social relations. The fact that the government has in mind solely the fiscal aim of securing revenue does not alter the social consequences of the particular revenue system. In modern times social conditions are influenced to a large extent by changes in wealth. Every tax necessarily affects the wealth of individuals, and if we could in all cases trace the final consequences of even a "purely fiscal" tax, all kinds of unforeseen results, social as well as fiscal, or perhaps better, social because fiscal, would disclose themselves. Economics and finance deal not with intentions, but with results. The function of fiscal science is to point out to the legislator the necessary results of his actions.

The distinguishing mark of modern social science is that it endeavors to explain not only what is, but also what should be. All practical action is thus brought to the crucible of justice, and all systems of taxation are put to the test of conformity with this principle, irrespective of the intentions of the legislator. The great problem which still remains, however, is to elucidate the exact nature of this economic justice. Every one agrees that the essential ingredients of this scheme are equality, or uniformity, and universality of taxation. When, however, an attempt is made to interpret them and to outline the practical form which these principles should take, there is considerable disagreement, because the actual nature of the principles has not been thoroughly analyzed. It betokens, however, a step forward in all practical finance that a more or less conscious effort is everywhere being made to bring the tax system into some manner of conformity with the principle, however dim its outlines may be.

II

The second point, which differentiates modern taxation from that of the past, is the emergence of the new economic substratum of society. These new facts of fiscal importance may be summed up under the following heads:

First, the increasing economic significance of the laboring class, with the corresponding growth in the importance of popular consumption. It is not meant by this to imply any depreciation of the rôle played by capital. On the contrary, it is a platitude to say that this is preëminently the capitalistic age. What it is intended to emphasize is that precisely because of the growth of modern economic well-being, the great mass of the community, represented by the laborers, are acquiring an increased consuming capacity and that their demand is the very tap-root of modern progress. The recognition of this fact has brought about vast changes in modern tax systems.

In the second place we have to note the coming to the fore of the corporation as the typical form of modern business enterprise. The evolution from the individual to the early partnership, from the partnership to the joint-stock company, from the joint-stock company to the corporation, and from the corporation to the trust is one of the most instructive lessons in institutional development. Finance has not to study it, but to accept it. Tax systems framed upon the assumptions of the older conditions, where corporate activity was the exception rather than the rule, are manifestly inadequate and belated.

The third change consists in the growing importance of the problem of franchises. This is not the same as the corporate problem, although often confused with it. A franchise may assume many forms. It may be a patent or copyright in the hands of an individual; it may be the privilege of inheriting property, whether that privilege be granted to a single person or a group; it may be a right accorded to corporations to utilize opportunities which originally belonged to the community, and which are for sufficient reasons given away. Such privileges and franchises have indeed existed from of old, but the complexity of modern society and the immense increase of public wealth have vastly enhanced both their extent and their significance. How to analyze them, how to measure them, and how to fit the result into the system of public revenue is becoming one of the most subtle and difficult problems, which will, no doubt, long perplex the trained student as well as the legislator.

The fourth change is the economic revolution affecting the distribution of governmental authority as between the general and the local government. The cause of this change, as is well known, is not only the forging to the front of the interests of peace rather than of war, but above all, the agglomeration of modern population into urban centers. With the segregation of wealth and property into great local masses, there is coming the need of administering to the wants of such complex aggregates. Accordingly, while the last century has shown a great increase of national expenditure and

income, there has been a far larger growth in local expenditures and incomes. And whereas formerly local taxation could be treated as a relatively unimportant appendage to national taxation, it now claims a distinct and separate place of its own.

Side by side, however, with this localization of wealth there has been a counter-movement in the direction of the nationalization of wealth, in the sense of nationalization in the opportunities of securing wealth. The economic activities of to-day have far outgrown the swaddling-clothes of former times. Business enterprise not only covers the whole country, but encircles the globe. Citizenship in the various commonwealths of a federal state, like Germany, Australia, Switzerland, or America, has become in great measure meaningless because its economic basis has been so effectively weakened. In all federal states, therefore, the problem of taxation is complicated by the difficulty of correctly apportioning the burdens among the constituent commonwealths. In every country, federal or not, a similar difficulty exists as between the local government and the state government. Problems of double taxation resting upon interstate and interlocal complications arise to confront us at every turn.

The fifth and final point is that of modern social solidarity. In former times the close relation subsisting between the various branches of productive enterprise in the community was beclouded by the predominant social and political influence secured by some one factor. In an economy based upon slavery the only importance of a slave is that of a working-tool; in an economy based upon the predominance of the large landowner, the function of the moneyed and commercial interests is apt to be overlooked. In the early stages of the factory system, where the mass of the laborers are regarded from the point of view of production rather than from that of consumption, it is natural that the socialistic conception of class conflict should emerge. A more careful study, however, of modern industrial society has shown that while indeed there is no such thing as a natural harmony of interest, there is a distinct and inevitable influence, sometimes for good, sometimes for evil, exerted by each factor of production upon the other, and by each social class upon its neighbor. Laborers and capitalists, landowners and traders, factory owners and financiers, are pursuing their own interests, and in so doing they necessarily react upon the interests of the others.

The distinguishing mark of modern economic life in this respect is the realization of these close economic interrelations. The machinery of production has become so subtle and so complex that the disarrangement of any one part throws the whole out of gear. The overburdening of any one class may have the most unlooked-for consequences upon another. Taxation, as a weapon of retaliation, often proves to be a boomerang. An undue pressure on a

railroad may decrease facilities rather than increase revenue. The assessment of mortgages may hit the farmer rather than the money-lender. The taxation of the laborer may limit the market rather than increase the profits of the capitalist. Whether we desire it or not, modern economic conditions are engendering a situation where every one is in a larger sense his brother's keeper and where at all events it is unsafe to disregard the often hidden and recondite, but none the less active, influence exerted by each economic class upon the others.

All these changes in economic life have affected the practical system of taxation throughout the world. They have created new problems for the scientific student. The justification of finance, however, as a science, rests upon the correlation of fiscal problems with economic principle. We thus come to the third part of the discussion, the influence of economic analysis on fiscal facts.

III

The first result of economic analysis was to show the errors of a tax system resting exclusively or in great part upon consumption. The theory of consumption as the test of faculty or ability to pay was promulgated in the later middle ages by reformers who despaired of reaching the privileged class in any other way. Every man, it was said, must consume, and the more idle a man is, the more luxuries will he consume. A consumption tax thus seemed to be the sole method of securing universality of taxation. To these considerations there was added the thought on the part of some that so far as the working-classes were concerned, taxes on the necessities of life would be admirable, in that they would compel the laborers to work harder.

In opposition to this view, a more careful economic analysis disclosed the fact that a tax on consumption, regarded as a universal system, was unwise and unjust — unwise because a tax on mere luxuries would be most disappointing in the yield; unjust because a tax on necessities would fall with crushing severity on those classes which could least afford to bear the burden. Above all, it was recognized that by checking consumption we were thereby checking production, and that a general tax on consumption would possess most of the disadvantages of a tax on production and few of its advantages. Consumption taxes, therefore, as a sole or chief reliance of the government, have been fast disappearing. One of the first acts of the American Government in Cuba and the Philippines was to abolish the *consumo* tax; and it is well recognized that the continuance of the municipal *octroi* in France and Italy is deplored by all serious students.

The next triumph of economic theory was to disclose the dangers of a system of taxation resting on production and exchange. In one sense indeed every tax that is not a tax on consumption may be regarded as a tax on production, for all wealth consists either of producers' goods or of consumers' goods. It would, therefore, seem to be impossible to avoid the imposition of taxes on production. In the sense in which the term has usually been employed, however, a tax on production has denoted a tax imposed directly, and at a late stage, on the process of completing the finished article. Regarded in this light, such taxes manifestly impede the process of production and are to be deprecated because they affect the able and the shiftless producer alike. Taxes on production often put a premium on inefficiency and are apt to clog the wheel of industrial progress. The tendency of modern statesmanship has accordingly been away from reliance on such methods.

Perhaps the greatest change in fiscal theory during the nineteenth century has been, thirdly, to analyze and to explain the need of taxing shares in distribution rather than consumption or production. A vast amount of ingenuity has been expended upon the attempt to disclose the real meaning of faculty or ability to pay as measured by the property or the income of the individual. When we come to consider the facts, however, there are two striking considerations that confront us. The first is the pitifully small proportion that the income tax bears to the total revenue. In France, for instance, there is no income tax at all, and even in England and Germany the proceeds of the income tax are utterly insignificant when compared to the total revenue, state or local. The scientists may discuss and do discuss the problems of progression and differentiation of taxation, and all of the discussions rest on the assumption that the burdens upon the individual must be in a certain proportion to this income; yet we find as an actual fact that only a most beggarly proportion of the taxes in the civilized countries of to-day stand in any direct relation to the income of the taxpayer.

Not alone do the income taxes form so small a part of the whole, but furthermore, in most countries the so-called income taxes are really not income taxes at all in the sense of taxes on the personal income of the individual. In England, for example, it is well known that the so-called income tax is merely a collection of taxes on the thing which yields the income rather than on the person who receives it. That is, it is a collection of taxes on produce and not on income. The only exception is the famous schedule "D," which is notoriously the least successful of all. It may be claimed indeed that in Prussia the income tax is really what it purports to be, but all who have made a study of the system know that when similar methods were employed in England at the beginning of the nineteenth century,

they proved to be a dismal failure. The English administrators consider the principle of their tax far superior to that of the Prussian; and to the extent that this contention is justified, the superiority rests upon the fact that the tax is not one on personal income. Even in Prussia itself, the home of efficient bureaucracy, the tax is sometimes called the *Lug und Trug System.* The same repugnance to the personal element in the income tax which is found in England explains why it has been impossible to introduce the system into France, with its still lively recollection of the abuses of personal taxation under the *ancien régime,* and explains also why the income tax is beyond the range of practical politics in the United States.

We thus find the remarkable fact that while the science of finance has been elaborating its fundamental principles, it has succeeded in some respects, but has failed in others in imprinting its conclusions upon legislation. It has brought the actual taxes on consumption and production, to a great extent, into line with its conclusions, but it has spent most of its time during the nineteenth century in working out the principles of an income taxation, which is either not accepted in legislation, or which, if accepted, is realized to so small an extent and in such a half-hearted way as to be on the whole of little consequence.

The conclusion is hence forced upon us that the fiscal analysis has not proceeded sufficiently far. We are indeed grateful for what has been accomplished, but we have evidently not yet reached the goal. We need, therefore, a fourth and final economic principle to help us thread our way through the maze of actual fiscal facts.

This fourth principle is that of the social versus the individual basis of taxation. The conception which has dominated fiscal science until lately is the individual conception. Direct taxes have in theory been preferred to indirect taxes, because they were supposed to rest where they were imposed, and thus to help in securing justice as between individuals. The goal of all taxation was the attainment of a method in harmony with individual faculty. The first serious breach in this doctrine was made by the diffusion theory of taxation. The diffusion theory erred, indeed, in that it went too far, attempting to show that every tax is always and inevitably shifted off from the shoulders of the original payer. The value of the diffusion theory, however, consists in the fact that it put the problem in the right way, by presenting the societary aspects of taxation.

Nevertheless, the diffusion theory made the situation too simple. It has quite correctly been termed superficial and one-sided. To make it at all serviceable, it needs to be supplemented by another theory, which I have taken the liberty of calling the absorption theory of taxation. The absorption theory rests upon the doctrine of capitalization. That is to say, where the tax is not shifted from

the seller to the buyer and where the economic good has a rental value as well as a capital value, the tax which remains on the commodity and which, therefore, to that extent diminishes the income to be derived from it, *i. e.*, its rental value, must also proportionally diminish its capital value. The selling or capital value of anything is always the capitalization of the actual and prospective rental or income value. As a consequence, through this familiar principle of capitalization the new purchaser of the commodity will buy it at the reduced price, and will thus virtually buy himself free from taxation. The tax is discounted, or absorbed, in the new and lower price.

A new tax on city real estate, for instance, will either be diffused by increasing the rents of the tenants, or it will be absorbed in the sense that when the property changes hands the new purchaser will pay a price reduced by the capitalization of the tax.

The combination of the diffusion and the absorption theories of taxation explains several things. It explains why the theoretic distinction between direct and indirect taxes based upon the alleged facts of incidence is erroneous. It explains why in spite of this theory the great mass of revenue to-day continues to be raised in the shape of indirect taxes. It explains why in countries like the United States the state and local taxes, although still in principle levied on persons, are slowly coming to be imposed on things rather than on persons; it explains why in France personal taxes have been impossible since the Revolution; it explains why in England, with the exception of a single schedule of a single tax, the whole system of taxation is based on things and not on persons; it explains why, even in Germany, where the personal and individual elements of the problem have been emphasized in theory, the personal share in actual taxation is so very insignificant; it explains, finally, why the legal decisions on taxation in the United States are coming to be in harmony with the truer economic doctrine of universality and equality of taxation. For this does not mean that everybody must be taxed alike, but only that all the members of a given class must be taxed alike, while there may be the greatest diversity between classes. An equal tax on all corporations does not imply that each individual stock- or bond-holder who may have bought after the tax was imposed pays equally, just as little as an equal tax upon real estate implies that each individual land- or house-owner everywhere and necessarily bears the burden of the tax.

In short, the individual point of view in taxation, which assumes that justice can be done by assessing each individual directly and in first instance, rests upon an analysis suited only to primitive economic conditions. The social point of view is that of modern economics, which seeks to trace the workings of general economic law and to

study the forces which affect the distribution of the social income. The individual point of view is not only inadequate in itself, but fails to explain the development of modern taxation. The social point of view, resting upon a combination of the absorption and diffusion theories, is alone in harmony with the facts of fiscal life. It is safe to predict that when once this is accepted, the most fruitful work of the future in the science of finance will consist in the elaboration in detail of the conditions and the limits of the absorption and diffusion theories.

IV

Regarded from this point of view, a new light is thrown on the practical problems throughout the world. The most important of these pressing problems are as follows: First, the reform of so-called indirect taxation. The social consequences of indirect taxation are now recognized to an ever-increasing extent. So far as taxes on consumption are concerned, it is fairly well appreciated that the commodity taxed must possess the mingled qualities of a necessity and a luxury; if it possess only the characteristics of a luxury the revenue will be insignificant; if it possess only the qualities of a necessity, it will fall with undue severity on the modest consumer; if, however, it combines both characteristics, namely, that of wide use and at the same time that of a certain degree of dispensability, the revenue is apt to be large and elastic and the burden not too severe. The number of consumable commodities that unite both these characteristics is small, and hence we find everywhere throughout the civilized world the tendency to restrict taxes on consumption to very few but very lucrative articles.

In the second place we find well-nigh everywhere the abandonment of the old general property tax regarded as a personal impost. In England and Germany it disappeared during the eighteenth century; in France it was abolished by the Revolution; in America, where the economic conditions brought it into life during the eighteenth century and the early part of the nineteenth, it is beginning to break up in those sections where the agricultural economy is giving way to a commercial and industrial economy.

Thirdly, we notice everywhere the replacing of the general property tax by taxes on the thing rather than on the person. In the local tax on real estate this process has been carried almost to completion. In Europe, for instance, the taxes levied on the land and on the house are assessed irrespective of the owner or of the relations that may be entered into between owner and tenant. Everywhere in Europe the tax is a tax on the produce of the land or house — that is, upon what it yields in the shape of rent or of profits equivalent to rent. In some countries, as in England, the tax is not paid by the owner at

all, but by the occupier. Even in the United States the tax is assessed on the parcel of real estate and not on the individual who owns it. Whether the owner or some one else pays the tax is immaterial, and if the tax is not paid, no regard is paid to the owner and the land itself is sold. We could get scarcely further away from the old idea of individual taxation. The tax is a tax on the thing and not on the person.

In the other so-called direct taxes, a similar development is to be observed. The business taxes in Europe are levied upon the business as such and not upon the owner of the business. The inheritance tax is levied upon the inheritance and not upon the individual who receives the inheritance. The general land tax in England — the last vestige of the medieval general property tax upon individuals — has actually become a redeemable rent-charge. Even the income tax, which in theory is assuredly personal, has, as we have already stated, almost completely lost its individual character and has become in great measure a tax upon the thing affording the income rather than upon the person receiving the income. In the United States the so-called personal tax, that is, the tax on individuals according to their personal property, is fast becoming a farce in all the older centers. It is especially noteworthy that in the one place where a recent intelligent effort has been made to reform the personal property tax — the city of Chicago — it is becoming in effect a tax upon the thing rather than upon the person, and is being limited to the business capital, assessed upon groups or classes of business men rather than upon the individuals composing the classes. The problem is really a deeper one than the German scientists have usually recognized. It is not so much a conflict between a tax upon produce and a tax upon income as it is a conflict between the social and the individual bases of taxation.

In the fourth place, we find everywhere an increasing importance attached to corporations as the source of revenue. In Europe this process is somewhat concealed because of the inclusion of the revenue from corporations in the income tax, just as in many of the younger American commonwealths the revenues figure in the general property tax. In the older states corporation taxes are put into a separate category, and in some states, as in New York, they are even called indirect taxes in contradistinction to the direct or property taxes. Everywhere, however, they form a problem of increasing importance and present an admirable example of what is meant by taxation from a social rather than from an individual point of view. Taxation of the corporation does not mean taxation of the security-holder who has purchased the stock or bond from the original holder.

The main outlines of the development of the immediate future, throughout the world, are thus fairly clear. Each country will con-

tinue to have its particular problems based upon its special economic and political needs. Everywhere there will continue to be an attempt to realize the principle of fiscal justice, interpreting it, however, more and more from the point of view of social interrelations rather than from that of individual conditions. The statesmen and scientists alike will find the great difficulty of the future to consist in attaining this due proportion between the undoubted needs of the individual and the consequences of his participation in the social group. For we must not forget that while it is necessary to regard the ultimate results of all fiscal policies, the immediate results are often of primary practical importance. The conflict between immediate and ultimate results is another way of putting the contrast between the individual and social aspects of finance. To realize the truth contained in the latter, without disregarding the legitimate importance of the former, is the problem reserved for the coming decades.